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EMIR – the road ahead is clearing … an update

First phase – interest rate derivatives

After months of internal wrangling between the European Commission and ESMA over the details on the first asset class to be subject to the phased implementation of mandatory central clearing under EMIR - interest rate derivatives - the relevant regulatory technical standards were finally settled with the publication in the Official Journal on 1 December 2015 of Commission Delegated Regulation (EU) 2015/2205 (the "**IRD RTS**"). The IRD RTS came into force on 21 December 2015. Mandatory central clearing of specified classes of interest rate derivatives will start on 21 June 2016 for clearing members. Other firms subject to the clearing obligation will, from 21 December 2015, have 12 months, 18 months or 36 months respectively to prepare, depending upon their categorisation.

In this briefing (which is an update of our January 2015 briefing) we remind firms of the circumstances in which the EMIR clearing obligation will apply to OTC derivative contracts and set out the now-confirmed details of the first phase of mandatory clearing.

Part A: The clearing obligation and its application to counterparties – a reminder

The permutations

Mandatory central clearing will apply where both counterparties to a relevant standardised OTC derivative contract are subject to the EMIR clearing obligation: this will be the case where both counterparties are financial counterparties ("**FCs**"), both counterparties are non-financial counterparties above the prescribed clearing threshold ("**NFC+s**") or one counterparty is an FC and the other is an NFC+. It follows that if one of the counterparties is below the clearing threshold (an "**NFC-**"), the clearing obligation will not apply.

Financial counterparties include credit institutions, MiFID investment firms, UCITS and their management companies, AIFs managed by AIFMs authorised or registered in accordance with AIFMD and institutions for occupational retirement provision ("**IORPs**").

What if one or both of the counterparties is outside the EEA?

Where a non-EEA counterparty enters into a standardised OTC derivative contract with an EEA counterparty that is an FC or an NFC+, whether that contract requires central clearing under EMIR will depend upon the "deemed" status of the non-EEA counterparty – in other words, how would it be classified under EMIR if it were established in the EEA? If that deemed classification would mean that it would be subject to the clearing obligation (that is, it would either be an FC or an NFC+), then the clearing obligation will apply.

Where two non-EEA counterparties (that would be subject to the clearing obligation if established in the EEA) enter into a standardised OTC derivatives contract with each other the EMIR clearing obligation will not apply unless the contract has a "direct, substantial and foreseeable effect" in the EEA or the purpose of the arrangement is to defeat the object, spirit and purpose of EMIR (this is an anti-avoidance provision). Regulatory technical standards specify the circumstances in which a contract would be deemed to have a direct, substantial and foreseeable effect in the EEA and those cases where the anti-avoidance provision would apply.

Why the references to the "EEA"?

EMIR, as a Regulation, has direct effect in all EU Member States. However, it is a text with EEA relevance and therefore applies more widely across the European Economic Area, subject to it being adopted under local law in the three EEA member states which are not members of the EU – Iceland, Liechtenstein and Norway. This briefing assumes such adoption and we therefore refer throughout to the "EEA".

Part B: The clearing of interest rate derivatives

The mandated classes

The IRD RTS declares four classes of interest rate OTC derivatives to be subject to mandatory central clearing:

Interest rate OTC derivatives classes subject to the clearing obligation – the mandated classes

- **Basis swaps** denominated in EUR (referenced to Euribor) or in GBP, JPY or USD (referenced to LIBOR), in each case with a maturity of between 28 days and 50 years
- **Fixed-to-floating interest rate swaps** denominated in EUR (referenced to Euribor) or in GBP, JPY or USD (referenced to LIBOR), in each case with a maturity of between 28 days and 50 years
- **Forward rate agreements (FRAs)** denominated in EU (referenced to Euribor) or in GBP, JPY or USD (referenced to LIBOR), in each case with a maturity of between 3 days and 3 years
- **Overnight index swaps (OIS)** denominated in EUR (referenced to EONIA), in USD (referenced to FedFunds) or in GBP (referenced to SONIA), in each case with a maturity of between 7 days and 3 years

Subject to satisfying a number of conditions, contracts concluded with covered bond issuers or with cover pools for covered bonds are carved out of the above classes.

The implementation schedule

The mandated interest rate derivatives classes outlined above will be subject to mandatory clearing on a phased basis depending on the size and nature of the counterparties. In this regard, market participants subject to the clearing obligation (see above) have been divided into four categories and the implementation date will vary depending upon which category the counterparty falls into.

Mandated interest rate derivatives: phased implementation of clearing obligation

Category	Type of firm	Date on which clearing obligation takes effect – new contracts	Frontloading of pre-existing contracts?
1	**Clearing members** of any CCP authorised or recognised to clear at least one of the classes of mandated interest rate derivatives and which are **financial counterparties (FCs)**	**21 June 2016**	Clearing members which are financial counterparties only: For any mandated class of contract entered into or novated **before 21 February 2016**, with a remaining maturity on 21 June 2016 of at least 50 years (basis swaps and fixed-to-floating interest rate swaps) or 3 years (FRAs, OIS) For any mandated class of contract entered into or novated **on or after 21 February 2016** (but before 21 June 2016), with a remaining maturity on 21 June 2016 of at least 6 months (all mandated asset classes)
	Clearing members of any CCP authorised or recognised to clear at least one of the classes of mandated interest rate derivatives and which are **NFC+s**		**No frontloading**
2	**Financial counterparties (FCs)** (including **AIFs managed by an authorised or registered AIFM**) (other than Category 1 clearing members) whose aggregate month-end average of outstanding gross notional amount of all non-centrally cleared derivatives transactions for January, February and March 2016 is ***above EUR 8 billion***. For AIFs, this calculation is made at fund level; for other FCs, this calculation is made on a group basis.	**21 December 2016**	For any mandated class of contract entered into or novated **before 21 May 2016**, with a remaining maturity on 21 December 2016 of at least 50 years (basis swaps and fixed-to-floating interest rate swaps) or 3 years (FRAs, OIS) For any contract entered into or novated **on or after 21 May 2016** (but before 21 December 2016), with a remaining maturity on 21 December 2016 of at least 6 months (all mandated asset classes)
	Alternative investment funds that are NFC+ (AIF NFC+s) whose aggregate month-end average of outstanding gross notional amount of all non-centrally cleared derivatives transactions for January, February and March 2016 is ***above EUR 8 billion***.		**No frontloading**
3	**Financial counterparties (FCs)** (including **AIFs managed by an authorised or registered AIFM**) and **alternative investment funds that are NFC+s (AIF NFC+s)** which are not Category 1 or Category 2 (i.e. the outstanding gross notional amount calculation is EUR 8 billion or less)	**21 June 2017**	**No frontloading**
4	**Non-financial counterparties above the clearing threshold (NFC+s)** that do not belong to Category 1, Category 2 or Category 3	**21 December 2018**	**No frontloading**

Notes to the table:

The categories above include third country (non-EEA) "deemed" FCs or NFC+s (see "*The clearing obligation and its application to counterparties – a reminder*" above).

On the date on which the clearing obligation takes effect, it will apply to all mandated interest rate derivatives entered into or novated on or after that date and, if relevant, any pre-existing contracts subject to the frontloading obligation (see below).

The EUR 8 billion threshold applicable to Category 2 and Category 3 firms is calculated on a group basis, except in the case of UCITS and AIFs, where it applies on a fund level (see "*What is the EUR 8 billion threshold and how is it calculated?*" below).

Where a transaction is entered into between two in-scope counterparties within different categories (e.g. a Category 2 financial counterparty ab ove the EUR 8 billion threshold and a Category 3 financial counterparty), the later of the two dates will apply – i.e. 21 June 2017 rather than 21 December 2016 (and no frontloading will apply).

There is a derogation for certain intra-group transactions between counterparties (other than Category 4 counterparties) in the same full accounting consolidation group, where one of them is established in a non-EEA country, subject to certain conditions.

What is the EUR 8 billion threshold and how is it calculated?

It is a quantitative threshold linked to the level of activity of the relevant counterparty – and its group – in *all* OTC derivatives, across *all* asset classes, which are not centrally cleared. This includes, but is not limited to, foreign exchange forwards, swaps and currency swaps. The relevant counterparty must calculate *the outstanding gross notional amount* of such non-centrally cleared derivatives on an aggregate basis across the whole group (or, importantly, at *fund* level in the case of AIFs and UCITS), taking the average of the three month-end snapshots taken on 31 January 2016, 29 February 2016 and 31 March 2016.

In other words, in order to determine whether they are Category 2 or Category 3 firms and whether the clearing obligation goes live on 21 December 2016 or 21 June 2017 in respect of mandated OTC derivative contracts entered into or novated by then, relevant firms (i.e. FCs which are not Category 1 firms and AIF NFC+s), need to be collating the relevant data **as from the end of this month (January 2016)** and **for the next two following months (February and March 2016)** in order to be able to perform the necessary quantitative threshold calculation.

Frontloading

The IRD RTS also address a complicated technical nuance of EMIR known as "frontloading". Under EMIR, it is possible for pre-existing derivatives transactions to become subject to the mandatory clearing obligation despite the fact that they were entered into or novated before the relevant start date referred to above.

Frontloading will only be an issue for Category 1 clearing members which are financial counterparties or Category 2 entities which are financial counterparties (including AIFs managed by an authorised or registered AIFM) whose aggregate month-end average of outstanding gross notional amount of all non-centrally cleared OTC derivatives transactions for the first three months of 2016 is in excess of EUR 8 billion.

What does this mean for AIFs?

AIFs managed by authorised/registered AIFMs (FCs):

Where an AIF is managed by an authorised or registered AIFM and is a counterparty to one or more transactions in mandated OTC derivatives, it is *not* a question of *whether* it will be subject to the mandatory clearing obligation, but *when*. In relation to mandated interest rate derivatives, and assuming it is not a clearing member, whether an AIF falls within Category 2 or Category 3 (and therefore whether the clearing obligation in respect of mandated interest rate derivatives takes effect on 21 December 2016 (with frontloading) or 21 June 2017 (without frontloading)) turns upon the result of the EUR 8 billion threshold calculation (see above).

Importantly, for AIFs (and UCITS) the EUR 8 billion threshold is assessed *individually* at *fund level* (i.e. there is no need to aggregate non-centrally cleared derivatives across a consolidated group for accounting purposes). Remember that the calculation must be done on a gross notional basis across all outstanding transactions.

AIFs not managed by authorised/registered AIFMs (NFCs):

Any AIF that is not currently managed by an authorised or registered AIFM will, by definition, be a non-financial counterparty. So an AIF marketed in the EEA under a national private placement regime (NPPR) – i.e. an EEA or non-EEA AIF managed by a non-EEA AIFM and marketed in accordance with Article 42 AIFMD – will be an NFC.

Whether that AIF NFC will be subject to mandatory clearing at all depends on whether it is an NFC+ (or would be "deemed" to be an NFC+ if it were established in the EEA). In order to do this, a separate calculation is required under criteria set down in a separate Commission Delegated Regulation (No.149/2013) to determine whether the NFC would be above the clearing threshold: this broadly involves working out whether, in respect of certain derivative asset classes, the gross notional value of OTC derivative contracts which are not objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the

NFC or its group is above a prescribed threshold. These thresholds are high, but if one threshold is crossed for one asset class the counterparty becomes an NFC+ even if none of the other thresholds is crossed:

NFCs and the clearing obligation thresholds
OTC credit derivatives – EUR 1 billion
OTC equity derivatives – EUR 1 billion
OTC interest rate derivatives – EUR 3 billion
OTC foreign exchange derivatives – EUR 3 billion
Other OTC derivative contracts – EUR 3 billion

If the AIF is an NFC- (actual or deemed) – i.e. because none of the thresholds outlined above has been crossed – it will simply not be subject to the clearing obligation.

If the AIF is an NFC+ (actual or deemed) – i.e. because one or more of the thresholds outlined above have been crossed – it will be subject to the clearing obligation, but the date on which this takes effect in relation to mandated interest rate derivatives will depend on whether it falls within Category 2 or Category 3. As before, this turns upon the result of the EUR 8 billion threshold calculation (see above).

For AIFs, the EUR 8 billion threshold determining whether Category 2 or Category 3 status applies is assessed *individually* at *fund level* (i.e. there is no need to aggregate non-centrally cleared derivatives across a consolidated group for accounting purposes). Remember that the calculation must be done on a gross notional basis across all outstanding transactions.

What does this mean for pension funds?

IORPs are financial counterparties for the purposes of EMIR. However, there is a temporary exemption from the clearing obligation in respect of OTC derivatives that are "*objectively measureable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements*". This exemption is automatically available for IORPs in relation to such OTC derivatives. Certain other types of pension scheme arrangements have to apply to their competent authority in order to be granted the exemption.

The exemption is currently in place until 16 August 2017, although the European Commission has the option to extend the exemption for a further year. So, IORPs (which, based on the IRD RTS, would either be Category 2 or Category 3 financial counterparties depending upon the EUR 8 billion calculation) will in fact need to be in a position to submit any new mandated interest rate derivatives entered into on or after **17 August 2017** to central clearing (not 21 December 2016 or 21 June 2017). It is not yet clear if and how they would be subject to frontloading.

What should firms be doing to prepare for mandatory clearing of OTC interest rate derivatives?

All entities categorised as FCs or NFC+s (or managers acting for them) should be doing the following:

- Identify which of their OTC derivative counterparties will themselves be subject to the clearing obligation – i.e. are FCs or NFC+s (or deemed FCs or deemed NFC+s).
- Identify which of the classes of interest rate derivatives subject to the mandatory clearing obligation are, or will be, relevant to them.
- Consider whether an exemption or derogation will be available – for instance, in relation to covered bonds or intra-group transactions.
- In the absence of an exemption or derogation, determine which category of counterparty they will be for the purposes of the IRD RTS. Categorisation will determine the relevant date on which the clearing obligation

will start and (for financial counterparties) will have a bearing on whether frontloading will apply to them. Assuming it is not a Category 1 clearing firm, to determine whether the firm is within Category 2 or Category 3 (and therefore whether the clearing obligation will go live on 21 December 2016 or 21 June 2017) it will be necessary to generate a calculation of *gross* notional value, on an aggregate basis across the whole group, of all outstanding OTC derivatives, taking the average of three month-end "snapshots" taken on 31 January, 29 February and 31 March 2016. In the case of AIFs and UCITS, the calculation is restricted to the position of the *fund* only. In any case, the calculation is one of *gross* notional value across all outstanding contracts (with no allowance for any positions which might net off). Firms should keep a record of the calculation in order to be able to evidence the basis upon which they determined their categorisation.

- If they have not already done so, establish and finalise their clearing arrangements as a matter of the highest priority. A recital to the IRD RTS acknowledges the fact that most counterparties will get access to a CCP by becoming a client or an indirect client of a clearing member and that this process may require between 12 and 18 months depending on the legal and operational capacity of counterparties (hence the 21 December 2016 and 21 June 2017 effective dates).

- Following on from the previous point, consider the documentation they will need to enter into with their selected clearing provider as part of their negotiations. ISDA has published a template addendum to its Master Agreement as a starting point for negotiation with a clearing member of a CCP.

- Remember that mandatory clearing in respect of prescribed interest rate derivatives is just the start. Mandatory clearing of other asset classes will be phased-in in due course. Final draft regulatory technical standards have been delivered by ESMA to the European Commission in relation to FRAs and fixed-to-floating interest rate swaps denominated in Norwegian Krone (NOK), Polish Zloty (PLN) and Swedish Krona (SEK), and in relation to index credit default swaps. We may expect to see the published RTS in 2016. No RTS are currently proposed at this stage in relation to non-deliverable forwards or lookalike/flexible equity derivatives and contracts for difference.

- Remember also that EMIR's risk mitigation requirements apply to all OTC derivative transactions that are not centrally cleared. The legislation for most of these requirements has been in place for some time and firms should be complying with them. The only outstanding issue for non-centrally cleared OTC derivative contracts is that relating to the exchange of collateral and bilateral margining. In their Second Joint Consultation Paper issued in June 2015, the European Supervisory Authorities (ESAs) proposed a phasing-in of the obligations to exchange initial margin and variation margin, with only the largest of firms becoming subject to the requirements in September 2016 and the final RTS on this are expected to be published in early 2016.

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